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Folder ID: 30489677

Series: Meeting and event briefing materials

Dates: 02/04/1998 – 02/12/1998

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Meeting: GEF/Carbon-Initiative Investment
Fund Design and Operation

Thursday, February 12, 1998
4:00 - 5:30 p.m.

MC 12-755 Meeting Room
(Beside Mr. Sandström's Office)

The World Bank Group
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President Wolfensohn - Briefing Book for President's Meetings - Meeting Material
Global Environment Facility [GEF] and Carbon-Initiative Investment Fund Design

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A. CLASSIFICATION

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B. SUBJECT: MEETING: GEF/CARBON-INITIATIVE INVESTMENT FUND DESIGN AND OPERATION (B) (N) TIME: 4:00 - 5:30 P.M. VENUE: MC 12-755 (MEETING ROOM) CONTACT: KEN NEWCOMBE @ 36010 (1/14) KRISTINE SCHWEBACH @ 35251 IN ATTENDANCE: JDW, EL-ASHRY, WATSON, NEWCOMBE, CKW, I. JOHNSON, SERAGELDIN, E. TEMBURKE, A. RACZYNSKI (IFC), MARISELA // (2/10) ADDED PER RACSZYNSKI: LOUIS BOORSTIN, CHIEF OF ENVIRONMENTAL UNIT, IFC // (2/10) ADDED PER WATSON: CHARLES DI LEVA, LAWYER (LEGEN) ANCHOR FOR THIS MEETING: OPC MTG. ON FEB. 13 & MARCH 2ND BOARD DATE // NOTES: (1/14) ITEM MOVED FROM FEB. 4 DUE TO EAP TRAVEL // (B) BY NEWCOMBE // DUE: FRIDAY, FEB. 6 EXC: MM // LFG (1/7) // ALI (1/14)

DATE: 02/12/98

C. VPU

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E. COMMENTS:

OFFICE MEMORANDUM

DATE: February 10, 1998

TO: Mr. James D. Wolfensohn, EXC

FROM: Robert T. Watson, ENV



EXTENSION: 36965

SUBJECT: **Briefing Note on GEF/CIF Design and Operation**
Thursday, February 12 at 4:00 p.m. - Room MC12-755

Attached to this memorandum you will find a brief note on the the three topics we would like to discuss at the meeting scheduled for Thursday, February 12.

- The Carbon Investment Fund: Design and Legal Structure
- GEF-GCI Collaboration
- GEF-Bank Strategic Partnership on Renewable Energy Market Development

Attachment

cc: Messrs./Mme. C. Koch-Weser (MDOMD); M. El-Ashry (GEF); I. Serageldin (ESDVP);
A. Raczynski (CTEDR); M. Montoliu Munoz (EXC); C. Di Leva (LEGEN);
K. Newcombe, I. Johnson, E. Tandberg (ENV)

The Carbon Investment Fund

Design and Legal Structure

The proposed design and structure of the CIF is being advanced through a feasibility study being prepared by a consortium of consultants organized by Eenergy International Corporation in close coordination with Bank staff. Although the design and structure is not finalized, input from the January 29-30 meeting with CIF investors suggests the Fund is likely to take the following shape:

- The CIF would be similar to a World Bank trust fund, with the Bank receiving a fee for acting as administrator of the CIF.
- The CIF would be within the range of US\$100-120 million, based upon investments from twelve to sixteen investors, both public and private.
- The Bank would enter into a trust agreement with the investors. The agreement would require investors to provide promissory notes or irrevocable stand-by letters of credit for the amount to be paid by them into the Fund.
- Payments into the Fund would be made by installments based on a pre-determined schedule, and would be held in a trust fund-account.
- Each investor would be entitled to a corresponding percentage of the aggregate carbon emission reduction units ("carbon offsets") produced by the Fund.

The Bank would make its investments in projects on the basis of "**Investment Guidelines**" which would be developed in consultation with the participants. Once a project is selected, the Bank, as administrator of the CIF, would enter into an agreement with the relevant host country. The agreement would specify the amount to be paid to the host, and the procedures for withdrawal of the funds. Initially, disbursements would be made to finance the cost of the investment needed for the project. Subsequently, the balance of the amount would be withdrawn and disbursed against the delivery of carbon offsets. The quality of the offsets and the delivery of payment for the offsets would be determined by the processes of certification and verification carried out by an external party. It is expected that the cost of abating carbon emissions would be less than the market price as a result of the relatively low marginal abatement costs in the EITs and developing countries as compared to the high marginal abatement costs in the industrialized countries. The difference provides an added incentive- a share of the trade surplus- for the host country to participate in the carbon offset project.

After **verification** of the carbon reductions, the Fund would facilitate the transfer of carbon offset certificates from the host country to the investors on pro-rata basis. Depending upon the status of the international and national climate and legal and regulatory regimes, it is envisioned that investors could then have the following choices:

- use their carbon offset certificates to cover international or national obligations in lieu of domestic reductions, or,
- sell the certificates in the emerging carbon offsets market.

Given that the Bank cannot guarantee that the UNFCCC process would eventually authorize certification of the carbon offsets, investors would not be guaranteed that any carbon offsets would be recognized by the UNFCCC process or, indeed, that any particular volume of carbon offsets would be generated by the projects. However, due diligence would be applied to ensure that the projects meet "good practice", and independent certification companies would verify the carbon emission reductions. The actions to be taken by the Bank and the investors in the event the project fails to achieve the targeted level of emission reductions would need to be further explored. For example, the Bank would need to consider whether project agreements with the hosts should provide for cross-default where there is parallel Bank financing.

Risk to the Bank

While the Bank could be exposed to reputational risks should the projects fail to produce the anticipated carbon offsets, the CIF is expected to be designed to pass all financial risk to investors. The CIF would act solely as an intermediary between investors and the offsets suppliers.

The CIF would make investments in projects designed to reduce carbon emissions and thereby produce carbon offsets. Investors would be entitled to receive from project entities carbon offset certificates representing certified carbon reductions. The certificates would be distributed to investors pro rata based on their relative investment. The WB would not have any financial stake in these transactions and would not provide a guarantee of delivery of the offsets to the investors.

The CIF faces the responsibility risk of supplying sufficient projects to deliver the offsets for such investments. While the operations of the Fund suggest that third party projects may be included in the initial Fund, all, or at least a majority of the projects will come from the Bank's pipeline. Efforts to establish a pipeline of projects have revealed that a sufficient number of carbon offsets projects will be available through the Bank's pipeline for the current potential investment.

In the current nascent carbon market, (equilibrium) market price signals are unclear. There are a few price signals for carbon offsets transactions in the current market, ranging from less than a dollar per ton carbon to \$10-\$20 per ton carbon. Price differences can be explained by expected quality differentials among the carbon offsets, including risk profiles and the credibility of the offset. While the CIF faces some risk that the market price will be lower than expected, the marketing strategy of the CIF in the short term is to facilitate the development of a carbon offset market defined by high quality standards and secure offset generation that includes benefits to all market participants in order to build confidence among potential hosts and investors.

CIF Cost Structure

The CIF would charge a management fee in order to cover the overhead costs of the Fund management team. In addition, the costs of the individual projects, paid for by the investment funds, will include incremental project preparation and appraisal costs; and costs of certification and verification during the period over carbon offsets are to be certified (typically 8-10 years and less than the economic life of the project). These costs are broadly comprised of:

- Fund management overheads: \$6 million;
- incremental project preparation, appraisal and supervision costs: \$4 million;
- certification and verification costs: \$5 million¹

This cost structure does not include provision to pay back the New Products Committee for its investment of the initial working capital for the prototype CIF.

Implementation Partnerships and Collaboration

The regions will collaborate with the CIF in developing projects which generate carbon offsets for the CIF and the IFC has committed to examine its pipeline and explore with its clients the potential for bringing IFC projects to the CIF. This collaboration is done under contract with the Fund management unit, currently the Carbon Offsets Unit in the Environment Department.

External collaboration with CIF implementation takes two forms:

- GEF-Bank collaboration to ensure synergy with and avoid competition between GEF and GCI operations, in particular for the prototype CIF;
- Third party carbon offset deal supply by MFIs, the private sector or others. For example, discussions are underway with the EBRD to explore its potential role as a supplier of carbon offset deals in the initial CIF.

CIF Investors

CIF Investors are likely to include both governments and private sector entities. In the Fund, governments and private sector entities would be looked to for a fixed investment of \$10 million and \$5 million, respectively. Currently 5 governments and 12 companies have signed memoranda of understanding indicating that they have an interest in investing in the CIF (see Annex 1) and have actively participated in pre-investment consultative meetings. Several other governments and companies are also currently considering investing in the CIF.

The prospective investors met in September 1997 and January 1998 to provide guidance to the Bank on their preferences for the design and operation of the CIF and the investment criteria they would like the Fund manager to apply in selecting projects for carbon offset

¹ The cost estimates for Fund management and for certification/verification reflect that this is a completely new business in a nascent market and their share of the total costs will be reduced in subsequent replenishments.

investment. The proposed investment criteria provided by the investors during these consultations include the following:

- the pipeline should consist of projects in the EITs and in the developing countries;
- the projects should result primarily from the World Bank Group pipeline, but would also be open to third party projects;
- the pipeline should include projects primarily from the energy sector, but also from forestry;
- the projects should be consistent with the Country Assistance Strategies;
- the quality of the projects should be high and assure acceptance of the offsets in national and international regulatory regimes;
- the projects should be cost-effective and clearly additional (both financially and environmentally);
- the CIF should be complementary to other financing mechanisms;
- the price of the offsets generated should fall within the range of \$10 - \$30 per ton carbon, including the “resource rent”; and,
- the technology should be low-risk and cost-effective.

Hosts for CIF Investments

Consultation with potential host countries in EITs and the G77 are planned for March and May, 1998. Prior to December, 1997, the Bank’s CIF pipeline development initially focused on EITs, but will now be extended to all regions. A key mechanism for generating deal flow and building client capacity to participate in the CIF and other carbon offset trading activities is the National Strategy Studies Program launched initially by the Bank and the Government of Switzerland. The NSS is now a multi-donor program which will cover 20 countries over the next two years (see Annex 2).

Timeline

In the short term, the following list outlines the most critical deadlines for the creation of the initial Fund:

February, 1998	Presentation to the Operations Policy Committee
March, 1998	First Consultative Group Meeting with Hosts
March, 1998	Bank Executive Board Seminar
May, 1998	Second Consultative Group Meeting with Hosts
May, 1998	Bank Executive Board Approval of the CIF
May, 1998	Distribution of CIF Agreement/Prospectus to Investors
June, 1998	Third Consultative Group Meeting with Investors
July - September, 1998	Conclude negotiation of CIF Agreements with Investors and initiate calls for capital
July - September, 1998	Negotiation of First tranche of CIF Projects (3-4 projects)

The development of the GCI thus far has been supported by approximately \$3 million for FY98. From FY99 onwards, we expect that the development costs will be covered by the revenue from the investors' installment payments. As a result of the internal complexities for the investors in the movement of these funds, and the expectation of many investors that the November, 1998, Buenos Aires meeting of the Conference of the Parties to the Climate Convention will clarify many uncertainties, it is possible that a shortfall of operation financing will occur between the end of FY98 and the receipt of capital. Therefore, it would be imprudent of the Bank to assume that any capital called in September would be available before the end of calendar year 1998. ***Hence, the CIF will require additional financing of working capital from the Bank to bridge this gap.***

ANNEX 1

Memoranda of Understanding Already Signed by

Company/Government	Business	Country
Government of Finland		Finland
Government of the Netherlands		Netherlands
Government of Norway		Norway
Government of Sweden		Sweden
Government of Switzerland		Switzerland
Holderbank	Construction materials	Belgium
Ontario Hydro	Power	Canada
Elkraft	Power	Denmark
IVO Group	Power	Finland
Statoil	Oil	Norway
Naturkraft	Power	Norway
Vattenfall	Power	Sweden
VTZ	Financial intermediaries	Switzerland
World Business Council for Sustainable Development	Umbrella	Switzerland
Chevron Corporation	Oil	USA
British Petroleum	Oil	United Kingdom

Decision on MOU Pending		
Tokyo Electric Power Company	Power	Japan
Overseas Economic Cooperation Fund (OECF)	semi-Government	Japan

ANNEX 2

Donor Countries

<i>Europe/Former Soviet Union</i>			
Country	Source of Funding	Completed	Status
Bulgaria			Under discussion
Czech R	Swiss	completed	Study completed. Final seminar planned for 17-18 February, 1998
Hungary			Preparation work completed, pending funding decision
Kazakhstan	Swiss	in progress	Study to be completed by April 1998
Poland			Under discussion
Romania	Swiss		Under discussion
Russia	Swiss, Finnish	in progress	First draft of the final report due in February. Report to be finalized by April 1998
Slovak Rep.	Swiss	in progress	To be completed in February 1998; seminar planned end of March 1998
Slovenia			Preparation work completed; pending funding decision
Ukraine	Swiss		Under discussion
Uzbekistan	Swiss	Feb. 1	Preparation work completed. Implementation to begin February 1998
Turkmenistan			Under discussion
<i>Developing Countries</i>			
Country	Source of Funding	Estimated Starting Date	Status
<i>Africa</i>			
Egypt			Under discussion
South Africa			Under discussion
Zimbabwe	Swiss	Feb/ March 1998	Under preparation
<i>Asia</i>			
China	Swiss	May 1998	Considered
India	Swiss		Under discussion
Indonesia			Under discussion
Philippines	Swiss	March 1998	Under preparation
Vietnam			Under discussion
<i>Latin America</i>			
Brazil	Swiss		Considered
Colombia	Swiss	March 1998	Under preparation
Mexico		April/ May 1998	Under discussion

OFFICE MEMORANDUM

DATE: February 4, 1998

TO: Mr. Caio K. Koch-Weser, MDOMD

FROM: Mohamed El-Ashry, GEF
Robert T. Watson, ENV

M. El-Ashry
R.T. Watson

EXTENSION: 33202
36965

SUBJECT: **GEF-GCI Collaboration**

This memorandum will discuss two aspects of ongoing collaboration between the Bank and GEF: terms of our collaboration in the Global Carbon Initiative (GCI), and our planned strategic partnership to accelerate market development for renewable energy.

GEF-GCI Collaboration

We are pleased to confirm that we have reached an understanding on the form our collaboration should take between the GEF and the Bank in moving forward on the Global Carbon Initiative and to establish a Carbon Investment Fund (CIF). This understanding applies only to first "prototype" Carbon Investment Fund (CIF) and will be reviewed when current uncertainties are removed and subsequent carbon investment funds are warranted.

In essence, our collaboration will take the form of informal but comprehensive consultation between us at all stages of the development and implementation of the prototype CIF product.

Specifically, collaboration between us will include:

- GEF Secretariat membership of the GCI strategic planning group;
- GEF Secretariat participation in each CIF investor's meeting;
- Regular consultation between GEF Secretariat and the Bank's GCI management team on the development of investment guidelines and their respective climate change mitigation pipelines to maximize synergy and avoid competition between them at the level of operational strategy and individual deal flow.

GEF-Bank Strategic Partnership on Renewable Energy Market Development

In the proposed partnership, GEF would earmark approximately \$150 million annually in grant and concessional financing for investment projects fitting the relevant GEF Operational Programs, to be allocated flexibly. The Bank would ensure a leveraging ratio on the order of 1:4 (ratio of GEF to non-GEF financing). Progress on market

competitiveness would be indicated by the percentage of GEF funds in total project costs declining over time. A substantial rise in Bank loans and guarantees for renewables would also be expected.


This initiative responds to several challenges identified in recent Bank and GEF strategic planning efforts. In the medium to long-run, renewable energy technologies remain highly promising due to their environmental benefits and potential for cost competitiveness. The successful development and deployment of these technologies is also essential to meet the goals of the recently negotiated Kyoto Protocol on climate change.

In the short term, however, the conditions for introducing these technologies is worsening in most countries as competition from conventional sources increases, deregulation and privatization focus power markets on efficiency and least cost options, and financing for household level renewable energy technologies is high cost or unavailable.

The Bank and the GEF are among the few institutions with the funds, skills, and mandate necessary to address these worsening conditions. However, the energy business of the Bank is currently declining and country assistance strategies almost uniformly emphasize other priorities. The meeting with Mr. Wolfensohn therefore comes at an extremely opportune time in the effort to review our strategic approach to this sector, and converges with decisions being made on the Bank's own longer term strategic focus.

cc: Messrs. I. Serageldin (ESDVP); K. King, D. Ahuja (GEF); I. Johnson, K. Newcombe,
L. Vidaeus, C. Feinstein (ENV)

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